

810-27-1-4-.01 Multistate Tax Compact Regulation Definitions.

(1) *Scope.* These Regulations are intended to set forth rules concerning the application of the apportionment and allocation provisions of Article IV ("Division of Income") of Section 40-27-1, Code of Alabama 1975, titled "Multistate Tax Compact". The apportionment rules set forth in these regulations are applicable to any taxpayer having business income, regardless of whether or not it has nonbusiness income, and the allocation rules set forth in these regulations are applicable to any taxpayer having nonbusiness income, regardless of whether or not it has business income.

(a) The only exceptions to the allocation and apportionment rules contained in these regulations are those set forth in Regulation 810-27-1-4-.18 pursuant to the authority of Section 40-27-1, Code of Alabama 1975, Article IV.18.

(b) These regulations are not intended to modify existing rules concerning jurisdictional standards.

(c) The examples used throughout these regulations are illustrative only and do not purport to set forth all pertinent facts.

(2) *Business and Nonbusiness Income Defined.* Section 40-27-1, Article IV.1.(a) defines "business income" as income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations. In essence, all income which arises from the conduct of trade or business operations of a taxpayer is business income. For purposes of administration of Section 40-27-1, Article IV, the income of the taxpayer is business income unless clearly classifiable as nonbusiness income.

(a) Nonbusiness income means all income other than business income.

(b) The classification of income by the labels occasionally used, such as manufacturing income, compensation for services, sales income, interest, dividends, rents, royalties, gains, operating income, nonoperating income, etc., is of no aid in determining whether income is business or non-business income. Income of any type or class and from any source is business income if it arises from transactions and activity occurring in the regular course of a trade or business. Accordingly, the critical element in determining whether income is "business income" or "nonbusiness income" is the identification of the transactions and activity which are the elements of a particular trade or business. In general all transactions and activities of the taxpayer which are dependent upon or contribute to the operations of the taxpayer's economic enterprise as a whole constitute the taxpayer's trade or business and will be transactions and activity arising in the regular course of, and will constitute integral parts of, a trade or business. (See Regulation 810-27-1-4-.01(c) for more specific examples of the classification of income as business or nonbusiness income.)

(3) *Business and Nonbusiness Income: Application of Definitions.* The following are rules and examples for determining whether particular income is business or nonbusiness income.

(a) *Rents and Royalties from real and tangible personal property.* Rental and royalty income from real and tangible property is business income if the property with respect to which the income was received is used in the taxpayer's trade or business or incidental thereto and therefore is includable in the property factor under Regulation 810-27-1-4-.10.

1. EXAMPLE: The taxpayer operates a multistate car rental business. The income from car rentals is business income.

2. EXAMPLE: The taxpayer is engaged in the heavy construction business in which it uses equipment such as cranes, tractors, and earth-moving vehicles. The taxpayer makes short-term leases of the equipment when particular pieces of equipment are not needed on any particular project. The rental income is business income.

3. EXAMPLE: The taxpayer operates a multistate chain of men's clothing stores. The taxpayer purchases a five-story office building for use in connection with its trade or business. It uses the street floor as one of its retail stores and the second and third floors for its general corporate headquarters. The taxpayer manages and leases the remaining two floors to others. The rental of the two floors is incidental to the operation of the taxpayer's trade or business. The rental income is business income.

4. EXAMPLE: The taxpayer operates a multistate chain of grocery stores. It purchases as an investment an office building in another state with surplus funds and hires an unrelated property management company to manage and lease the entire building to others. The net rental income is not business income of the grocery store trade or business. Therefore, the net rental income is nonbusiness income.

5. EXAMPLE: The taxpayer operates a multistate chain of men's clothing stores. The taxpayer invests in a 20-story office building and uses the street floor as one of its retail stores and the second floor for its general corporate headquarters. The taxpayer hires an unrelated property management company to manage and lease the remaining 18 floors to others. The rental of the eighteen floors is not incidental to but rather is separate from the operation of the taxpayer's trade or business. The net rental income is not business income of the clothing store trade or business. Therefore, the net rental income is nonbusiness income.

6. EXAMPLE: The taxpayer constructed a plant for use in its multistate manufacturing business and 20 years later the plant was closed and put up for sale. The plant was rented for a temporary period from the time it was closed by the taxpayer until it was sold 18 months later. The rental income is business income and the gain on the sale of the plant is business income.

7. EXAMPLE: The taxpayer operates a multistate chain of grocery stores. It owned an office building which it occupied as its corporate headquarters. Because of inadequate space, taxpayer acquired a new and larger building elsewhere for its corporate headquarters. The taxpayer hired an unrelated property management company to manage and lease the old building. The property management company leased the building to an unrelated investment company under a five-year lease. Upon expiration of the lease, taxpayer sold the building at a gain (or loss). The net rental income received over the lease period is nonbusiness income and the gain (or loss) on the sale of the building is nonbusiness income.

8. EXAMPLE: The corporation is engaged in extracting natural resources. The corporation owns and operates or leases and operates mines or wells which are located in several states. For various reasons, the corporation ceases actual operation of the properties and leases or subleases mineral rights to others. Royalties are paid to the corporation by the operators based on units extracted and the royalty income is business income.

9. EXAMPLE: The corporation is engaged in lumber and related wood products business in various states. The corporation owns or leases timberlands which are used as raw materials for its lumber business. Some of the land is unsuitable and the corporation leases or subleases mineral rights to other parties. Royalties are paid to the corporation based on units extracted and the royalty income is business income.

10. EXAMPLE: The corporation acquires undeveloped land for future expansion of its multistate manufacturing business. The expansion plans are later discarded and mineral rights under the land are leased to others. The corporation receives royalties based on units extracted and the royalty income is nonbusiness income.

(b) *Gains or losses from sales of assets.* Gain or loss from the sale, exchange or other disposition of real property or of tangible or intangible personal property constitutes business income if the property while owned by the taxpayer was used in the taxpayer's trade or business. However, if the property was utilized for the production of nonbusiness income or otherwise was removed from the property factor before its sale, exchange or other disposition, the gain or loss will constitute nonbusiness income. See Regulation 810-27-1-4-.10.

1. EXAMPLE: In conducting its multistate manufacturing business, the taxpayer systematically replaces automobiles, machines, and other equipment used in the business. The gains or losses resulting from those sales constitute business income.

2. EXAMPLE: The taxpayer constructed a plant for use in its multistate manufacturing business and 20 years later sold the property at a gain while it was in operation by the taxpayer. The gain is business income.

3. EXAMPLE: Same as (ii) except that the plant was closed and put up for sale but was not in fact sold until a buyer was found 18 months later. The gain is business income.

4. EXAMPLE: Same as (ii) except that the plant was rented while being held for sale. The rental income is business income and the gain on the sale of the plant is business income.

5. EXAMPLE: The taxpayer operates a multistate chain of grocery stores. It owned an office building which it occupied as its corporate headquarters. Because of inadequate space, taxpayer acquired a new and larger building elsewhere for its corporate headquarters. The taxpayer hired an unrelated property management company to manage and lease the old building. The property management company leased the building to an unrelated investment company under a five-year lease. Upon expiration of the lease, taxpayer sold the building at a gain (or loss). The gain (or loss) on the sale is nonbusiness income and the rental income received over the lease period is nonbusiness income.

(c) *Interest.* Interest income is business income where the intangible with respect to which the interest was received arises out of or was created in the regular course of the taxpayer's trade or business operations or where the purpose for acquiring and holding the intangible is related to or incidental to such trade or business operations.

1. EXAMPLE: The taxpayer operates a multistate chain of department stores, selling for cash and on credit. Service charges, interest, or time-price differentials and the like are received with respect to installment sales and revolving charge accounts. These amounts are business income.

2. EXAMPLE: The taxpayer conducts a multistate manufacturing business. During the year the taxpayer receives a federal income tax refund and collects a judgment against a debtor of the business. Both the tax refund and the judgment bear interest. The interest income is business income.

3. EXAMPLE: The taxpayer is engaged in a multistate manufacturing and wholesaling business. In connection with that business, the taxpayer maintains special accounts to cover such items as workmen's compensation claims, rain and storm damage, machinery replacement, etc. The moneys in those accounts are invested at interest. Similarly, the taxpayer temporarily invests funds intended for payment of federal, state and local tax obligations. The interest income is business income.

4. EXAMPLE: The taxpayer is engaged in a multistate money order and traveler's check business. In addition to the fees received in connection with the sale of the money orders and traveler's checks, the taxpayer earns interest income by the

investment of the funds pending their redemption. The interest income is business income.

5. EXAMPLE: The taxpayer is engaged in a multistate manufacturing and selling business. The taxpayer usually has working capital and extra cash totaling \$200,000 which it regularly invests in short-term interest bearing securities. The interest income is business income.

6. EXAMPLE: In January, the taxpayer sold all of the stock of a subsidiary not involved in the same trade or business of the taxpayer for \$20,000,000. The funds are placed in an interest-bearing account pending a decision by management as to how the funds are to be utilized. The interest income is nonbusiness income.

(d) *Dividends.* Dividends are business income where the stock, with respect to which the dividends are received, arises out of or was acquired in the regular course of the taxpayer's trade or business operations, or where the purpose of acquiring and holding the stock is related to, or incidental to, such trade or business operations.

1. EXAMPLE: The taxpayer operates a multistate chain of stock brokerage houses. During the year, the taxpayer receives dividends on stock that it owns. The dividends are business income.

2. EXAMPLE: The taxpayer is engaged in a multistate manufacturing and wholesaling business. In connection with that business, the taxpayer maintains special accounts to cover such items as workmen's compensation claims, etc. A portion of the moneys in those accounts is invested in interest-bearing bonds. The remainder is invested in various common stocks listed on national stock exchanges. Both the interest income and any dividends are business income.

3. EXAMPLE: The taxpayer and several unrelated corporations own all of the stock of a corporation whose business operations consist solely of acquiring and processing materials for delivery to the corporate owners. The taxpayer acquired the stock in order to obtain a source of supply of materials used in the manufacturing business. The dividends are business income.

4. EXAMPLE: The taxpayer is engaged in a multistate heavy construction business. Much of its construction work is performed for agencies of the federal government and various state governments. Under state and federal laws applicable to contracts for these agencies, a contractor must have adequate bonding capacity, as measured by the ratio of its current assets (cash and marketable securities) to current liabilities. In order to maintain an adequate bonding capacity the taxpayer holds various stocks and interest-bearing securities. Both the interest income and any dividends received are business income.

5. **EXAMPLE:** The taxpayer receives dividends from the stock of its subsidiary or affiliate which acts as the marketing agency for products manufactured by the taxpayer. The dividends are business income.

(e) *Patent and copyright royalties.* Patent and copyright royalties are business income where the patent or copyright with respect to which the royalties were received arises out of or was created in the regular course of the taxpayer's trade or business operations or where the purpose for acquiring or holding the patent or copyright is related to or incidental to such trade or business operations.

1. **EXAMPLE:** The taxpayer is engaged in the multistate business of manufacturing and selling industrial chemicals. In connection with that business, the taxpayer obtained patents on certain of its products. The taxpayer licensed the production of the chemicals in foreign countries, in return for which the taxpayer receives royalties. The royalties received by the taxpayer are business income.

2. **EXAMPLE:** The taxpayer is engaged in the music publishing business and holds copyrights on numerous songs. The taxpayer acquires the assets of a smaller publishing company, including music copyrights. These acquired copyrights are thereafter used by the taxpayer in its business. Any royalties received on these copyrights are business income.

(4) *Proration of Deductions.* In most cases, an allowable deduction of a taxpayer will be applicable to only the business income arising from a particular trade or business or to a particular item of nonbusiness income. In some cases, an allowable deduction may be applicable to business income or several items of nonbusiness income. In such cases, the deduction shall be prorated among those items of nonbusiness income in a manner which fairly distributes the deduction among the classes of income to which it is applicable. Any allowable deduction that is applicable both to business and nonbusiness income of the taxpayer shall be prorated to each class of income in determining income subject to tax as provided below:

(a) *Interest Expense.* Interest expense shall be prorated to nonbusiness assets by multiplying total interest expense by the ratio of average cost of the nonbusiness assets to the average cost of the total assets. If any assets were acquired with stock of the taxpayer corporation, the value of such assets to the extent attributed to the taxpayer's stock shall be excluded from the computations.

(b) *Other Expenses.* Other type expenses applicable both to business and nonbusiness income shall be prorated in such a manner as to equitably assign such expenses to business or nonbusiness categories, as appropriate.

(c) *Year to year consistency.* In filing returns with this state, if the taxpayer departs from or modifies the manner of prorating any such deduction used in returns for prior years, the taxpayer shall disclose in the return for the current year the nature and extent of the modification.

(d) *State to state consistency.* If the returns or reports filed by a taxpayer with all states to which the taxpayer reports under Article IV of this Compact or the Uniform Division of Income for Tax Purposes Act are not uniform in the application or proration of any deduction, the taxpayer shall disclose in its return to this state the nature and extent of the variance.

(5) *Effective Date of Changes.* The additions and deletions in this regulation shall be effective for the tax years beginning after December 31, 1996.

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